ISLAMIC FINANCIAL SERVICES

1. The emergence of the Islamic economic system

The twentieth century has witnessed the emergence of an economic doctrine that calls itself "Islamic economics". The purpose of this doctrine is to establish an economic order that conforms to Islamic laws and traditions. Its two central principles are the prohibition of interest and the creation of a fairer social order.

While for centuries Muslims had developed ways to integrate their religious believes with economic realities, it was the context of the 1970 that allowed the implementation of some elements of the Islamic economic doctrine. With the massive increase in the oil price many Muslim countries suddenly disposed of a large amount of capital, and thus the demand for investment opportunities consistent with Islamic principles grew rapidly. At the same time, cooperation among Muslim countries was consolidated: in 1970 the Organization of the Islamic Conference (OIC) was created, which again established the Islamic Development Bank (IDB) in 1974. Moreover, the Iranian Revolution established a country that advocated the subordination of economic objectives to the general goal of restoring the predominance of Islam. Islamic economics was even propagated to be an alternative to the capitalist and socialist systems.

In reality, however, Islamic economics has never been able to established itself on an international level. Only Iran and Sudan have officially outlawed every form of interest and dispose of an economic system that operates almost entirely according to Islamic principles. Some elements of Islamic economics have nevertheless been retained by many countries and have, in the form of Islamic banking, even witnessed a boom in recent years.

2. Islamic finance and banking principles

Today, Islamic financial institutions operate in more than 75 countries, mainly in the Middle East and Southeast Asia. But also many Western Banks have an Islamic division (such as UBS, the Citibank Group or Deutsche Bank).[1]

Yet despite this recent boom, Islamic finance is still marginal compared to the global financial system. In most countries the Islamic banking sector remains quite limited, and the conventional financial sector largely prevails. Most Islamic countries thus have a dual financial system i.e. the conventional and Islamic financial system coexist (this is the case for example in Indonesia, Malaysia, Pakistan or the United Arab Emirates).

[1] Also several **Swiss banks** have branches in the Middle East offering services compatible with Islamic banking practices. To offer Sharia compliant products, **UBS** specifically set-up a subsidiary bank (Noriba) in Bahrain in 2002. Noriba was fully integrated into the UBS Middle East investment banking division in 2006. **Credit Suisse** has massively increased its presence in Dubai and Doha; some Sharia conform products have been launched at the end of 2006 and several will follow. The first Islamic private bank launched in Switzerland, the **Faisal Bank Switzerland**, opened its doors in Geneva in 2006.
Swiss banks entered the Islamic market later as the concurrence in London, but in the last few years they increasingly concentrate on Islamic banking. To underline this growing interest, the 10th edition of the annual Islamic Financial Forum was held in Zurich in November 2006.

The principles of Islamic financial practices are laid down in Islamic law, the *Sharia*. In general, the principles of Islamic banking are:

- The prohibition of taking interest (*Riba*). More precisely, the *Sharia* forbids transactions based on the exchange of a commodity of the same nature but with an augmentation or decrease in amount – e.g. money in exchange for more money. Within the Islamic scholars, there are, however, different interpretations on what *Riba* means. The modernist view states that reasonable interest rates are allowed and the conservative view believes that any kind of interest is wrong.

- The prohibition of unproductive speculation. According to Islamic law, all financial transactions must be based on real economic activities. Additionally, all transactions, whose outcome is highly uncertain, are forbidden.

- The prohibition of debt arrangements. Most Islamic financial institutions thus advise participatory arrangements between capital and labour; profit and loss are shared between the lender and the borrower.

- Islamic law prohibits the financing of “sinful activities” (*haram*) such as the production of alcohol and tobacco or gambling.

3. Islamic financial instruments

Islamic financial institutions have developed several financial products that comply with the *Sharia*. Many of these instruments are based on equity participation, but leasing and deferred payment contracts have become more frequent. Common are also loans without interest.

Lending, or financing, is normally backed by collateral; collateral free lending would be considered as containing a speculative element. Similarly, only investors with several years of successful business experience are financed to avoid speculation and moral hazard. These conditions are unfortunately not favourable for financial sector development and microfinance projects: the poor normally have no collateral to offer, and microfinance clients typically do not have several years of experience. There are, however, ways to offer microfinance services by means of Islamic financial instruments.

The most common Islamic financial products are[2]:

Mudaraba*:* (Trustee financing)
The Islamic financial institution finances the entire project while the entrepreneur offers his/her labour, time and management. The profits are shared between the capital provider and the entrepreneur at a predetermined ratio.

Musharaka*:* (Equity participation)
The Islamic financial institution finances an investment project jointly with an entrepreneur and also participates in its management. Profits and losses are shared among the partners based on their respective contributions.

In practice, Islamic banks also invest without getting involved in participation. To do so, they operate as intermediaries in sales:

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[2] See also annexe 1

***Murabaha**:* (deferred selling)
The Islamic financial institution purchases a commodity for the entrepreneur and resells it to him/her on a deferred sale basis with a fixed mark up.

Ijarah: (leasing)
The Islamic financial institution leases an asset to its customer on agreed lease terms for a fixed period of time. If he/she wishes, the customer can buy the commodity at the end of the period at an agreed price (minus the rental fees).

Quard al hassana: (beneficence, zero-return loans)
The Islamic financial institution issues a loan without interest. The institution is allowed to charge the borrower a service fee to cover the administrative expenses of the loan (provided that the fee is unrelated to the loan maturity or amount).

Takaful: (Insurance)
Islamic financial principles are also applied to insurance. The Sharia prohibits a conventional insurance, because it includes the presence of uncertainty and interest. Islamic insurance is therefore based on a collective sharing of risk by a group of individuals. In practice, takaful is a cooperative insurance: a policyholder pays his subscriptions for those who need assistance, as the concept of insurance where resources are pooled to help the needy does not contradict *Sharia*.

Savings:
Islamic banks also offer **saving deposits**. The depositor is either rewarded by a "gift" (instead of "interest") or the depositor receives a part of the bank's profit according to the participatory approach. In this case the depositor carries also the risk of the bank's eventual losses.

Remittances:
Muslim migrant workers often use the so-called Hawala system for money transfers into their country of origin. This informal value transfer system works via a network of hawala agents, who are present in several countries. The agents receive a commission for the transfer.[3]

3. The development of an Islamic financial market

An internationally organized Islamic financial market does not exist as such. There is neither a central authority governing the Islamic financial system. But as Islamic banking is growing, the development of a framework for supervising and regulating Islamic Banks has become increasingly important. Islamic banks are in each country regulated by the central bank, but many advance the view that Islamic banks should be governed by a supervisory regime that is entirely different from that of conventional banks. Moreover, there is no global Islamic authority that officially regulates which practices are allowed according to the *Sharia* and which ones are prohibited. The range of interpretations is accordingly large

In recent years the Islamic Development Bank has played a key role in developing internationally acceptable standards; the Accounting and Auditing Organization of Islamic

[3] **Remittances** contribute most significantly to the total capital flows of Muslim countries, in form of capital inflows as well as capital outflows. Among the world's top **receiver of remittances** are Lebanon (5,7 billion USD, 26% of GDP), Jordan (2,3 billion USD, 20% of GDP), Yemen (1,3 billion USD, 10% of GDP), Morocco (4.2 billion USD, 9% of GDP), Pakistan (3.9 billion USD, 4% of GDP) and Egypt (3.3 billion USD, 4 % of GDP; all data World Bank 2004).
The World's second largest **source of remittances** is Saudi Arabia. In the Sultanate of Oman, Qatar, Kuwait, and Bahrain the majority of workers are migrants and remittances outflow is respectively high. Most of the migrants working in these oil rich counties come from other Middle Eastern countries or from Asia (India, Pakistan, Bangladesh and The Philippines).

Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have also been active in this issue, and the IFSB has finalized standards on capital adequacy and risk management. These “Islamic standards” differ from classical bank standards, because Islamic banks operate rather as fund managers and investors, and not as classical commercial banks, due to the nature of the Islamic financial instruments (equity participation, risk sharing). It is thus recognized that the regulation and supervision of Islamic banks require a broader coverage that goes beyond the banking sector.

4. Islamic microfinance and financial sector development in Islamic countries

It can be argued that microfinance and Islamic finance pursue similar objectives: both endorse a holistic approach in supporting business and advocate entrepreneurship, productive activities and risk sharing. Additionally, Islamic religious principles mandate social responsibility and assistance for those in need, objectives that are frequently pursued by microfinance, as well.

Nonetheless, microfinance institutions, which operate according to Islamic principles, are still rare. That is not to say that microfinance is nonexistent in Islamic countries, but rather that microfinance institutions in Muslim countries normally operate according to conventional banking principles. Bangladesh for example has one of the most developed microfinance sector. The majority of the Bangladeshi MFIs, however, offer traditional interest-based commercial loans and savings products.

Consequently, poor people in Islamic countries are often excluded from the formal financial system, because they are reluctant to take interest-based credit, in part due to religious beliefs. The few existent Islamic banks serve rather larger companies and do not operate in remote regions. The degree of financial penetration thus remains limited in many Muslim communities.

The Islamic Development Bank (IDB) is the only agency specializing on Islamic finance. The IDB uses various *Sharia* compliant modes of financing to support development projects in its member countries. The IDB also finances microfinance schemes in Muslim countries through technical assistance and *Sharia* compliant concessional loans.

Also many Western donors and private microfinance investors are conscious that products need to be adapted to the local socio-economic and cultural characteristics. Some donors have thus supported the establishment of specialised Islamic microfinance institutions. Also a few Islamic commercial banks invest in Islamic microfinance.[4]

These are some examples of institutions and projects that offer Islamic microfinance:

The **Yemen Social Fund for Development** supported by the World Bank and EU, was the first microfinance programme in the region to develop a lending methodology based on Islamic banking practices. The Social Fund for Development is active in establishing Islamic MFIs and supports them with capacity building.

[4] The involvement of Islamic commercial banks in setting up Islamic MFI networks would be a powerful tool to spread Islamic microfinance. Today Islamic commercial Banks invest only selectively in microfinance, for example the Pakistani Bank Al-Habib http://www.bankalhabib.com/ps_IslamicBanking2.php.

One of the programmes supported by the Social Fund for Development is the **Hodeidah Microfinance Programme in Yemen.** The programme offers products according to the murabaha model (deferred selling contracts): a client designates the exact commodities he/she wants to buy. If the demand is approved, the loan officer purchases the items and resells it to the client, who can pay for the commodity in installements. These include the price plus a service charge.[5]

In the region of **Timbuktu in Mali**, **GTZ and KFW** carry out the Mali-North Programme, which has also included the creation of an inclusive financial institution: **Azaouad Finances plc.** Azaouad Finances has now become an Islamic Bank targeting small entrepreneurs of the region. The bank works according to the principle of equity participation and risk sharing: the bank shares the profit and losses of the borrower.[6]

In **Pakistan**, the **Network Leasing Corporation Limited,** a private sector financial institution uses the leasing instrument for its microcredit programmes. This allows collateral free loans for asset creation to very small entrepreneurs that are compatible with the Islamic law. **SDC** provides the Network Leasing Corporation Limited with technical assistance for capacity building in the framework of the Leasing to Micro and Small Enterprises programme (LMSE).

SDC's Micro and Small Enterprises programme (LMSE) also includes support to ORIX leasing, Cres Leasing and Al-Zamin leasing. The programme is executed by the Leasing Association of Pakistan. SDC offers support at three levels: through technical assistance for capacity building of the four leasing companies and the Leasing Association; financial assistance through loans for the leasing companies (credit lines at 7 % p.a.); and through an Innovative Project Fund. This fund is managed by SDC and channelled through the Leasing Association of Pakistan. The Innovative Project Fund offers grants to promote innovative instruments in SME lending, especially in rural areas.[7]

Additionally, **CGAP** has been active in researching the potentials and limits of Islamic microfinance. To facilitate the development of microfinance in the Middle East and North Africa, CGAP founded in 2005 the MENA initiative (MENA: **M**iddle **E**ast and **N**orth **A**frica) and opened a MENA office in Amman, Jordan. Furthermore, a resource website in the Arabic language (similar to the microfinance gateway) was launched. To implement these activities CGAP closely collaborates with the Microfinance Network of Arabic Countries (Sanabel).[8] However, these activities concentrate on making resources on microfinance available to the Arabic world, and did not only focus on Islamic microfinance.

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[5] Social Fund for Development: http://www.sfd-yemen.org/
Case study on the Hodeidah Microfinance Programme:
http://www.uncdf.org/english/microfinance/documents_and_reports/thematic_papers/islamic_banking/main_text.php#top

[6] http://www2.gtz.de/dokumente/AKZ/eng/akz_2005_microfinance/mali.pdf

[7] http://www.nlcl.net, http://www.intercooperation.ch/finance/download/divers/leasing-pakistan.pdf

[8] For the Arabic Gateway: http://arabic.microfinancegateway.org
The Arabic gateway is further supported by the Saudi Arabian private company Abdul Latif Jameel LTD. and the Grameen Foundation.
For information on Sanabel: http://www.sanabelnetwork.org/

It is interesting to note that donors and development banks from the Middle East (such as the Saudi Fund for Development, the Arab Fund for Economic and Social Development, or Kuwait) are much involved in co-financing projects of the International Fund for Agricultural Development (IFAD). IFAD – being a member of CGAP and involved in microfinance – has thus a potential to finance more proper Islamic Microfinance projects.

Conclusion

Even if Islamic banking has been growing in recent years, the sector remains marginal. It is, however, expected that the sector will further grow. Governance of Islamic banking will therefore become increasingly important.

The weight of money coming from Islamic countries and flowing into the international finance markets has increased since the 1970. Due to the recent evolution of the oil price it can be expected that still more "Islamic" money will be invested in the near future. In the international development scene, Islamic donors are still rare. Saudi Arabia is the most generous Islamic public donor with an official development assistance of 32,3 million USD (Source: World Bank, 2004).

Also Islamic microfinance has a big potential to grow. Microfinance is a very flexible tool, whose models can be tailored on the Islamic principles and Islamic law allows room for financial innovation. Pushed by the recent boom in both, Islamic banking and microfinance, Islamic microfinance is expected to become more common in the future.

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Annexe 1: Typology of Islamic financial products

(1) Financing products

Profit sharing financing products:	
Musharakah Musyarakah مشاركة	Equity participation, investment and management from all partners; profits are shared according to a pre-agreed ratio, losses according to equity contributions.
Mudarabah مضاربة	A profit-sharing partnership to which one contributes the capital and the other the entrepreneurship; or the bank provides the capital, the customer manages the project. Profit is shared according to a pre-agreed ratio
Qard Hasan Qard al-Hasanah حسن	Charitable loans free of interest and profit-sharing margins, repayment by instalments. A modest service charge is permissible
Wakalah وكالة	An authorization to the bank to conduct some business on the customer's behalf
Hawalah حوالة	An agreement by the bank to undertake some of the liabilities of the customer for which the bank receives a fee. When the liabilities mature the customer pays back the bank
Advance purchase financing products:	
Murabahah مرابحة	A sales contract between a bank and its customers, mostly for trade financing. The bank purchases goods ordered by the customer; the customer pays the original price plus a profit margin agreed upon by the two parties. Repayment by installments within a specified period
Istithna' إستثناء	A sales contract between bank and customer where the customer specifies goods to be made or shipped, which the bank then sells to the customer according to a pre-agreed arrangement. Prices and instalment schedules are mutually agreed upon in advance.
Mu'ajjal Bai al Salam بيع مؤجل	Purchase with deferred delivery: A sales contract where the price is paid in advance by the bank and the goods are delivered later by the customer to a designee
Ajaar Ijarah Ijarah Mutahia Bittamlik آجا	**Lease and Hire Purchase:** A contract under which the bank leases equipment to a customer for a rental fee; at the end of the lease period the customer will buy the equipment at an agreed price minus the rental fees already paid.

(2) Deposit products

Wadi'ah وديعة	Sight deposits, including current accounts (*giro wadi'ah*)
Mudarabah مضاربة	Deposit products based on revenue-sharing between depositor and bank, including savings products withdrawable at any time and time deposit products
Qard al-Hasanah حسن	Unremunerated deposit products, usually for charitable purposes (*widespread in Iran, but not found in Indonesia*)

(3) Insurance products

Tadamun, Takaful تضلمن - تكافل	Islamic insurance with joint risk-sharing

Taken from Seibel, pp.5- 6